Alphinity
INVESTMENT MANAGEMENT

Monthly comment – April 2013

Alphinity Wholesale Concentrated Australian Share Fund

Risk on or risk off?

Market comment

World equities rallied in April, with decent gains recorded in most major markets. The S&P/ASX 300 Accumulation Index (including dividends) put on 4.5%, taking its year-to-date increase to about 12%. The Fund did considerably better than that, increasing by almost 6% in April alone, which takes year-to-date performance over 17%. Parsing the numbers a little revealed an extraordinary skew in market returns: the top 10 stocks accounted for 89% of the performance of the ASX300 constituents, and the four major banks alone made up 63%. And despite the strong positive for the market overall, the simple average return of the ASX300 stocks in April was actually –5.5%, and the median return –2%. 58% of stocks were negative for the month. So a stock-picker's market remains well in force.

In recent times, a strong market has often been termed 'risk-on' (i.e. people are actively seeking higher-risk assets like equities) but the type of equities most sought this time have been decidedly 'risk-off': the best performing sectors in April were telecoms, banks and real estate investment trusts. The common factor here is high sustainable dividend yields, a theme we've been pointing to for some time. While we do not purposely seek stocks just for yield, we incorporate income and franking as part of our fundamental analysis and our portfolio includes many of the better yielding stocks, hence the very strong returns in April. We were also underweight in resource stocks, which in aggregate fell by about 4% during April.

Bond yields in some of the more challenged European economies were notable: in Spain and Italy 10 year yields fell to around 4%. These are levels not seen for some years, and suggest that the world is becoming less concerned about Europe. The best markets internationally (expressed in $A) with high-single-digit increases were Italy, Spain and Japan; the UK and most of the rest of Europe added 3-5% after positive currency moves. The US was up almost 2%. The various measures of Chinese shares were flat to down slightly.

Commodities were generally soft with iron ore and aluminium –2%, copper –6%, oil –7% and gold –8%.

Portfolio comment

The portfolio outperformed strongly in April with strong contributions from major banks ANZ, Westpac and telecommunications company Telstra, being underweight BHP and not owning Newcrest. The most significant detractors for the month were the overweights in Rio Tinto and Medusa Mining and being underweight in major banks NAB and CBA.

Fund details

Alphinity Wholesale Concentrated Australian Share Fund	
APIR code	HOW0026AU
FUM ($A million)	17.2
Asset allocation	Australian equity: 98.9%, Cash: 1.1%

Fund performance* – as at 30 April 2013

	1 month (%)	Quarter (%)	1 year (% p.a.)	2 years (% p.a.)	Since inception (% p.a.)
Alphinity Wholesale Concentrated Australian Share Fund	5.9	9.7	29.4	11.4	13.9
S&P/ASX 200 Accumulation Index	4.5	7.7	23.7	8.7	11.2

* **Returns are calculated after fees have been deducted, assuming reinvestment of distributions. No allowance is made for tax. Past performance is not a reliable indicator of future performance.** The Fund changed investment manager and investment methodology on 12 July 2010, at which time Alphinity Investment Management commenced managing the Funds and started the transitioning of the portfolios to a structure consistent with Alphinity's investment views. The transition was completed on 31 August 2010. Therefore, the inception date for the returns for the Funds is 1 September 2010. For performance for previous periods please contact Fidante's Investor Services team on 13 51 53 (during Sydney business hours).

Top 5 active overweight positions as at 30 April 2013

Alphinity Wholesale Concentrated Australian Share Fund

Issuer name	Index weight	Active weight
Westpac Banking Corporation	8.3%	6.3%
Australia and New Zealand Banking Corporation	6.9%	5.3%
Insurance Australia Group Limited	1.0%	3.5%
Lend Lease Corporation Limited	0.4%	3.4%
Rio Tinto Limited	1.9%	3.2%

Market outlook

Our previously-stated view of market prospects remains largely unchanged, and recent data points appear supportive of that view. The liquidity effect of low interest rates continues to underpin demand for equities, especially those with an attractive dividend yield. While this 'weight of money' argument is likely to remain in place for the foreseeable future, the market is no longer particularly cheap and companies actually delivering earnings growth will become more important for sustained returns. Lower interest rates should be supportive of economic activity and thus the earnings of many companies, however the improvements to date are evident only in pockets rather than across all economically sensitive sectors.

Encouragingly, the earnings upgrades we highlighted amongst retailers during the February/March reporting season have continued, although soft demand in other sectors such as building materials has resulted in several of those companies having to issue profit downgrades. With two of the three major banks having reported earnings in recent weeks, the thesis of low growth but good cost control and credit quality for the bank sector also remains intact. Resource companies continue to have the most negative earnings revisions due to falling commodity prices and until recently, the persistent strength in the Australian dollar. In summary the earnings picture, while not consistently positive, points to a continuation of low but stable growth for the banks, a slowly improving outlook for industrials and an uncertain earnings outlook for resources.

From a valuation perspective, it has become increasingly difficult to argue that the overall market is cheap. In particular the bank sector, which has perhaps been the largest beneficiary of investor demand for yield, is now fundamentally only supported by the large differential between dividend yields and bond yields. Importantly, bank dividends appear sustainable due to good credit quality and, perhaps somewhat ironically, limited capital requirements resulting from the low credit growth in recent years.

In the broader industrial sector, valuations for companies that are seeing an improving earnings outlook are broadly justifiable, in our view, while share prices for cyclical companies yet to see any improvement are likely to be vulnerable to disappointment. Following very poor performance over the last year, resource stocks are approaching levels at which the valuation support is becoming difficult to ignore. While earnings for base metals and precious metals in particular is still at risk, the worst of the relative under-performance of that sector is probably behind us – unless the commodity price declines accelerate or there is a better-than-expected earnings recovery in other parts of the market.

Portfolio outlook

The portfolio performed well in the month of April and also in the year to date. We are conscious that some of the themes which have assisted the performance of a number of the stocks in our portfolio have resulted in significant appreciation. Divergence in sector performance has been substantial over the last 12 months, no more so than between Banks and Resources. We have taken the opportunity of what seem to be fairly extreme valuations to reduce our underweight position in Resource stocks, however we remain cautious on the outlook for most commodities as we believe new supply is likely to be the most important determinant of commodity prices over the course of the year. Increased cost focus by resource company management and a lower Australian dollar may ease some of the margin pressure, but is unlikely to be enough for the stronger earnings outlook required for sustained outperformance, in our view.

Our preference at this point for retail stocks over other traditionally cyclical companies (eg. domestic building materials and media stocks) has been supported by recent company earnings updates, as noted above. While we continue to believe that lower interest rates will eventually improve earnings prospects for a broad set of companies, identifying individual companies as they enter their respective earnings upgrade cycle remains crucial. That will remain the focus of our efforts.

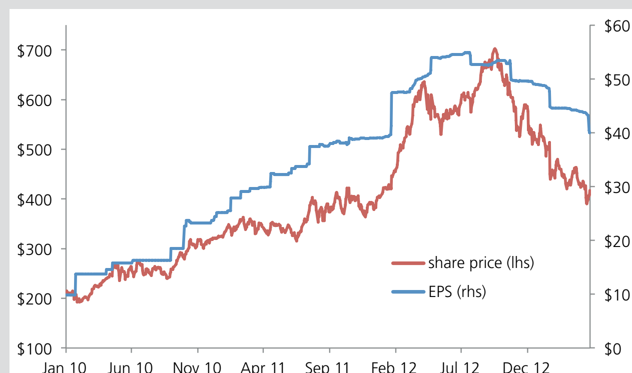
BTW

It's been a while since we wrote about Apple Inc, a fascinating company in itself but also one we think provides a great example of investor psychology at work. In September last year we noted that Apple had become the largest company in the world by market capitalization: briefly at $700 a share it was 'worth' more than $US600 billion: a single company valued at half of the entire top 300 companies in Australia! Various shareholders – both individual and institutional – were quoted in the financial press as saying 'it's going to $1,000' or 'I'll never sell it – in fact I'm buying more'.

Since then however Apple shares have been struggling. The death of Steve Jobs the prior year has been cited by some as the reason that Apple had lost its mojo, despite the fact it is still releasing great products and selling more and earning more than it ever has. Others looked at the introduction of a dividend last year as evidence that it is 'no longer a growth company' – therefore doesn't demand a high multiple. And it doesn't have a high multiple: on Bloomberg's measure of consensus numbers Apple is trading at less than 11 times this year's earnings. So why has the share price been struggling so much?

The answer, we feel, is quite simple and exemplifies a key aspect of Alphinity's process: the market's expectation of Apple Inc earnings peaked around the same time as its share price, and has been progressively and substantially downgraded ever since. The graph shows what the median of the 58 broker analysts (hard to believe there are that many firms!) following Apple stock believe the company will earn in its current financial year. The earnings estimate peaked around the same time as the Apple share price at about $55 per share and has since been downgraded to the current $39 per share. There has been a modest de-rating, but much of the share price fall can be explained by earnings expectations falling.

This is at the heart of Alphinity's process, and is the primary reason we look so closely at earnings expectations. It doesn't matter if a stock is 'cheap' (i.e. on a low multiple) if that apparent cheapness is merely due to analysts being too optimistic about future earnings. Equally, if a stock looks 'expensive', it could just be because analysts haven't quite appreciated the earnings potential of a company which is, in fact, quite reasonably priced. Because earnings revisions are typically serially correlated (i.e. a stock which has had upgrades in the past is likely to have more) and the trend tends to be sustained for meaningful periods, looking at a company's history of earnings revisions can give a guide to what will happen in the future. And when a turning point in the forecast earnings trajectory occurs in a stock, we look very carefully to judge whether it is the start of a new trend at which point our sell discipline kicks in. Had you sold Apple in late 2012 when the downgrades started, a lot of value might have been preserved.

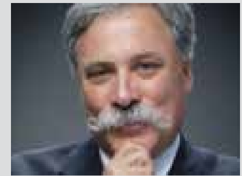


Traveller's tales

Bruce found himself in New York in April where he caught up with News Corporation. News, andparticularly its controlling shareholder Rupert Murdoch, polarises people and investors. On the one hand you have someone who, over half a century, has built up a hugely impressive and powerful media company encircling the globe. On the other, you have events like the phone-hacking scandal in the UK which has hurt many people and the full ramifications of which have possibly not yet been seen. However one positive outcome of that scandal has been a shift in the way the company and its board thinks, with the result that it has become a lot more 'investor-friendly'.

News has had a very strong balance sheet ever since a near-death experience when the early 1990s recession caught the company on the brink of insolvency. It had operated with an inefficient balance sheet in recent years (minimal debt and large cash balances), but with the depressed share price in 2011 in the wake of the scandal, the company finally listened to investor demands and instigated a substantial share buy-back – using some of the cash which was earning almost nothing to buy their own shares at a low multiple was very value-enhancing.

The company also announced that it would break into two parts: one owning the higher-growth electronic media assets and one owning the more challenged print assets. The idea is that the existence of low-multiple newspapers in its portfolio was causing US investors in particular to give the whole company a low valuation. By splitting off the 'unappealing' assets, they are more likely to value the sum of the parts greater than the current whole. After all, COO Chase Carey's moustache alone must be worth a few PE points!



News has been a strong contributor to Fund returns over the past couple of years as the market has gradually come to appreciate its potential, and its share price now largely reflects what we believe that potential to be. As a result, the position in our portfolio has now been sold. We will only know for sure in July when the two companies trade whether the theory that 'the sum of the parts is greater than the whole' has worked.

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